

Internal Revenue Service

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Date:

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LEGEND

Distributing =

Controlled =

Sub 1 =

Sub 2 =

LLC =

Business A =

Business B =

Business C =

Business D =

Agreement 1 =

Agreement 2 =

State X =

State Y =

Date 1 =

Date 2 =

Date 3 =

Year 1 =

Year 2 =

a =

b =

c =

d =

e =

f =

g =

h =

i =

i =

k =

l =

m =

n =

Dear _____ :

This letter responds to your September 16, 2008, request for rulings on certain federal income tax consequences of a series of proposed transactions. The information provided in that request and in later correspondence is summarized below.

The rulings contained in this letter are based upon facts and representations submitted by the taxpayer and accompanied by a penalties of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings. Verification of the information, representations, and other data may be required as part of the audit process.

In particular, this office has not reviewed any information pertaining to, and has made no determination regarding, whether the Split-Off (described below): (i) satisfies the business purpose requirement of § 1.355-2(b) of the Income Tax Regulations; (ii) is being used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (see § 355(a)(1)(B) of the Internal Revenue Code and § 1.355-2(d)); or (iii) is part of a plan (or series of related transactions) pursuant to which one or more persons will acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or the controlled corporation (see § 355(e) and § 1.355-7).

SUMMARY OF FACTS

Distributing, a closely held State X corporation, is the common parent of an affiliated group that files a consolidated return for federal income tax purposes. Distributing has outstanding one class of common stock (the "Distributing Common Stock") that is held by a shareholders (the "Shareholders"). All of the Shareholders are employees of Distributing or an affiliate. Certain Shareholders (not including Participating and Nonparticipating Shareholders, as defined below) hold options to acquire additional shares of Distributing Common Stock.

Distributing has historically entered into Agreement 1 with each Shareholder to provide for the repurchase of all Distributing Common Stock held by the Shareholder upon termination of the Shareholder's employment for any reason, voluntary or involuntary, with or without cause.

Distributing wholly owns Sub 1, Sub 2, and LLC, each of which is a holding company for direct and indirect domestic and foreign operating subsidiaries. Sub 1 and Sub 2 are State Y corporations, and LLC is a State Y single-member limited liability company that is disregarded as an entity separate from Distributing under § 301.7701-3. Sub 1 and its direct and indirect domestic and foreign subsidiaries (the "Business A Entities") are engaged in Business A. LLC and its direct and indirect domestic and foreign subsidiaries (the "Business B Entities") are engaged in Business B. Sub 2 and its direct

and indirect domestic and foreign subsidiaries are engaged in Business C. Distributing directly engages in Business D and indirectly engages in Business A, Business B, and Business C through domestic and foreign members of its separate affiliated group (the "Distributing SAG") as defined in § 355(b)(3) (the "Distributing Group"). Business A, Business C, and Business D are referred to herein as the "Businesses."

The financial information submitted by Distributing indicates that Business A (conducted by the Business A Entities) and Business B (conducted by the Business B Entities) each has had gross receipts and operating expenses representing the active conduct of a trade or business for each of the past five years.

Business B has a highly centralized, single-market, shorter-term focus, while the rest of Distributing's businesses are generally highly decentralized, broadly diversified, and focused on the longer term. This has resulted in disputes among the Shareholders over how Distributing should operate, manage, and grow its businesses. The managers of Business A ("Business A Management") and the managers of Business B ("Business B Management") attempted to neutralize these disputes in Year 1 by transferring the Business B Entities, and managerial control of these entities, to LLC. In connection with this restructuring, Distributing and LLC entered into Agreement 2, under which LLC is required to make an annual payment to Distributing equal to a stated percentage of the audited after-tax earnings of Business B (the "Required Distribution"). LLC has made the Required Distribution for each year since Year 1. For Year 2, the stated percentage will be b percent, and the Required Distribution is expected to be c. LLC anticipates approving the Year 2 Required Distribution before step (iv) of the transactions proposed below but not funding the payment until after-tax earnings of Business B for Year 2 have been audited.

Business A Management and Business B Management now believe that the adverse effects of their differing business philosophies can be eliminated only if LLC and the Business B Entities are completely separated from Distributing. Following such a separation, each management group will be able to focus solely on its business, undistracted by the continuing need to reconcile divergent views on business operation.

PROPOSED TRANSACTIONS

For what are represented to be valid business reasons, Distributing, Controlled, LLC, and the members of Business B Management that are Shareholders (the "Participating Shareholders") have proposed and partially undertaken the following transactions (the "Proposed Transactions"):

- (i) On Date 1, Distributing formed Controlled as a State X corporation.

- (ii) On or before Date 2, the Business B Entities will declare cash dividends payable to LLC for use by LLC in making the Year 2 Required Distribution. LLC will then approve payment of the Year 2 Required Distribution to Distributing on or before Date 2. Once the Year 2 after-tax earnings of Business B have been audited, which is expected to occur after the Split-Off described below in step (v), LLC will transfer the Year 2 Required Distribution to Distributing. It is expected that Distributing will use part of the Year 2 Required Distribution to pay creditors and redeem the Nonparticipating Shareholders (described below in step (vi)).
- (iii) Effective on Date 3, one or more of the Business B Entities will distribute to LLC an amount of cash (in addition to the Year 2 Required Distribution described above in step (ii)), and LLC will distribute the cash to Distributing. The amount distributed will equal the estimated difference between the fair market value of the Distributing Common Stock held by the Participating Shareholders and the fair market value of LLC (such difference, the “Estimated Amount”). The actual difference between the fair market value of the Participating Shareholders’ Distributing Common Stock and the fair market value of LLC will be determined as of Date 3 after the Split-Off (described below in step (v)) (the “Valuation Equalization Amount”). Distributing or Controlled (as the case may be) then will transfer cash to the other in an amount equal to the difference between the Valuation Equalization Amount and the Estimated Amount (the “True-Up Payment”). It is expected that Distributing will use part of the Estimated Amount and/or the True-Up Payment to pay creditors and redeem the Nonparticipating Shareholders (described below in step (vi)).
- (iv) Also effective Date 3 (but after step (iii)), Distributing will transfer all of the member interests in LLC (and therefore all of Distributing’s interest in Business B) to Controlled in exchange for Controlled stock (the “Controlled Common Stock”) and the assumption by Controlled of related liabilities (the “Contribution”).
- (v) Immediately after the Contribution, Distributing will distribute all of the Controlled stock to the Participating Shareholders in exchange for all of their Distributing Common Stock (the “Split-Off”).

- (vi) Immediately after the Split-Off, and pursuant to the terms of Agreement 1, Distributing will redeem all of the Distributing Common Stock owned by each Business B employee that is a Shareholder but is not a Participating Shareholder (the “Nonparticipating Shareholders”) in exchange for an amount of cash approximately equal to the fair market value of the Nonparticipating Shareholder’s Distributing Common Stock (the “Restrictive Stock Redemption”).
- (vii) Also immediately after the Split-Off, Controlled will redeem from each Participating Shareholder an amount of Controlled Common Stock that will result in each Participating Shareholder holding Controlled Common Stock having a fair market value of d (the “Post-Split-Off Redemption”). Concurrent with the Post-Split-Off Redemption, or shortly thereafter, it is expected that an employee of Business B will contribute d to Controlled in exchange for an e percent stock interest in Controlled (the “Post-Split-Off Exchange”).
- (viii) After the Post-Split-Off Redemption and the Post-Split-Off Exchange, Controlled will engage in a tax-free recapitalization under § 368(a)(1)(E) (the “Recapitalization”). Pursuant to the Recapitalization, the shares of Controlled Common Stock outstanding after the Post-Split-Off Redemption and Post-Split-Off Exchange will be converted into f shares of Controlled Class A Common Stock (“Class A Stock”) and g shares of Controlled Founders Common Stock (“Founders Stock”), with each share of Class A Stock and Founders Stock having a fair market value of h. Other than the right of the holders of Founders Stock to elect i members to the Controlled board of directors, there will be no differences in voting rights, rights to distributions, or rights upon liquidation between the Class A Stock and the Founders Stock. Both classes will be subject to certain restrictions on transfer and disposition.
- (ix) After the Recapitalization, it is expected that an additional j shares of Class A Stock will be sold to k Controlled employees at a price of h per share (the “Employee Class A Purchase”). The Employee Class A Purchase, and any subsequent similar offerings, would be undertaken to raise capital for Controlled’s operations and to provide Controlled’s employees with an additional interest in Controlled. Taking all of these current and future offerings of Class A Stock into account, the taxpayer does not anticipate that stock representing a 50-percent or greater interest (within the meaning of § 355(d)(4)) in Distributing or Controlled (including any predecessor or successor of any such corporation) will be acquired by any person or persons.

In connection with the Proposed Transactions, Distributing and Controlled have entered into a transition agreement relating to insurance, software licenses, and information technology support (the "Transition Agreement") that, among other things, (i) provides access to certain software equipment, (ii) provides for continuing electronic mail services and the forwarding of all electronic mail to the intended recipient, (iii) establishes a website strategy to notify potential customers of the transition, and (iv) provides for the use by Controlled of certain domain names. Most services under the Transition Agreement will terminate within 1 months after the Split-Off, but some will continue for up to m months.

In addition, Distributing and Controlled will enter into agreements that (i) permit Controlled and the Business B Entities to use the "Company" name for the m months immediately following the Split-Off and (ii) prevent Distributing and Controlled from competing with each other in defined markets for a period not to exceed n years with very limited exceptions (the "Business Agreements").

Payments made under the Transition Agreement will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length. No payments will be made under the Business Agreements.

REPRESENTATIONS

Distributing makes the following representations regarding the Proposed Transactions:

- (a) Pursuant to Agreement 2, LLC would be obligated to make the Required Distribution at the same time and in the same amount regardless of the Contribution or the Split-Off or any other aspect of the Proposed Transactions.
- (b) Any indebtedness owed by Controlled (or any entity controlled directly or indirectly by Controlled) to Distributing (or any entity controlled directly or indirectly by Distributing) after the Split-Off will not constitute stock or securities.
- (c) The fair market value of the Controlled Common Stock received by each Participating Shareholder will be approximately equal to the fair market value of the Distributing Common Stock surrendered by such shareholder in the Split-Off.
- (d) The cash received by each Nonparticipating Shareholder in the Restrictive Stock Redemption will be approximately equal to the fair market value of the Distributing Common Stock surrendered by such Shareholder.

- (e) No part of the consideration distributed by Distributing will be received by a Shareholder as a creditor, an employee, or in any capacity other than that of a shareholder of Distributing.
- (f) The five years of financial information submitted on behalf of Business A conducted by the Business A Entities that are members of the Distributing separate affiliated group ("SAG" as defined in § 355(b)(3)(B)), and on behalf of Business B conducted by the Business B Entities that are members of the Distributing SAG (and will be members of the Controlled SAG following the Contribution), is representative of the present operations of each business, and there have been no substantial operational changes in either business since the date of the last financial statements submitted. The Business A Entities and the Business B Entities are affiliated with Distributing in a manner that satisfies § 1504(a), without regard to § 1504(b). Immediately after the Split-Off, the Business A Entities will continue to be affiliated with Distributing in this manner, and the Business B Entities will be affiliated in this manner with Controlled.
- (g) Neither Business A conducted by members of the Distributing SAG nor control of an entity conducting this business will have been acquired during the five-year period ending on the date of the Split-Off in a transaction in which gain or loss was recognized (or treated as recognized) in whole or in part. Throughout the five-year period ending on the date of the Split-Off, the Business A Entities will have been the principal owners of the goodwill and significant assets of Business A, and they will continue to be the principal owners following the Split-Off.
- (h) Neither Business B conducted by members of the Distributing SAG (and to be conducted by the Controlled SAG following the Split-Off) nor control of an entity conducting this business will have been acquired during the five-year period ending on the date of the Split-Off in a transaction in which gain or loss was recognized (or treated as recognized) in whole or in part. Throughout the five-year period ending on the date of the Split-Off, the Business B Entities will have been the principal owners of the goodwill and significant assets of Business B, and they will continue to be the principal owners following the Split-Off.
- (i) Following the Split-Off, Distributing will continue the active conduct of Business A (through the Business A Entities), independently and with its separate employees.

- (j) Following the Split-Off, Controlled will continue the active conduct of Business B (through the Business B Entities), independently and with its separate employees.
- (k) The Split-Off is being carried out for the following corporate business purpose: to improve management fit and focus for both Businesses A and Business B by avoiding ongoing disagreements relating to the management of the Distributing Group's businesses that have hindered the operation and growth of the Businesses and Business B. The Split-Off is motivated, in whole or substantial part, by this corporate business purpose.
- (l) The Split-Off will not be used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both.
- (m) For purposes of § 355(d), immediately after the Split-Off, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Distributing stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Distributing stock, that was acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Split-Off.
- (n) For purposes of § 355(d), immediately after the Split-Off, no person (determined after applying § 355(d)(7)) will hold stock possessing 50 percent or more of the total combined voting power of all classes of Controlled stock entitled to vote, or 50 percent or more of the total value of shares of all classes of Controlled stock, that was either (i) acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Split-Off, or (ii) attributable to distributions on Distributing stock or securities that were acquired by purchase (as defined in § 355(d)(5) and (8)) during the five-year period (determined after applying § 355(d)(6)) ending on the date of the Split-Off.
- (o) The total adjusted basis of the assets that will be transferred to Controlled in the Contribution will equal or exceed the sum of (i) the total liabilities to be assumed (as determined under § 357(d)) by Controlled and (ii) the total amount of any money and the fair market value of any other property (within the meaning of § 361(b)) received by Distributing from Controlled and transferred to Distributing's creditors in connection with the reorganization.
- (p) The liabilities to be assumed (as determined under § 357(d)) by Controlled in the Contribution were incurred in the ordinary course of business and are associated with the assets being transferred.

- (q) The total fair market value of the assets transferred to Controlled in the Contribution will exceed the sum of (i) the amount of any liabilities assumed (within the meaning of § 357(d)) by Controlled in connection with the exchange, (ii) the amount of any liabilities owed to Controlled by Distributing that are discharged or extinguished in connection with the exchange, and (iii) the amount of any cash and the fair market value of any other property (other than stock and securities permitted to be received under § 361(a) without the recognition of gain) received by Distributing in connection with the exchange. The fair market value of the assets of Controlled will exceed the amount of its liabilities immediately after the exchange.
- (r) Distributing will neither accumulate its receivables nor make extraordinary payment of its payables in anticipation of the Split-Off.
- (s) No intercorporate debt will exist between Controlled (or any entity controlled directly or indirectly by Controlled) and Distributing (or any entity controlled directly or indirectly by Distributing) at the time of, or after, the Split-Off, other than intercompany loans or obligations that have arisen, or will arise, between the parties under the Transition Agreement or in the ordinary course of business.
- (t) Immediately before the Split-Off, items of income, gain, loss, deduction, and credit will be taken into account as required by the applicable intercompany transaction regulations (see §§ 1.1502-13 and 1.1502-14 as in effect before the publication of T.D. 8597, 1995-32 I.R.B. 6, and as currently in effect; § 1.1502-13 as published by T.D. 8597). Further, subject to adjustments for amounts paid after the Split-Off by Controlled or Distributing in connection with the True-Up Payment, any excess loss account Distributing may have in the Controlled stock or in the stock of any Controlled subsidiary will be included in income immediately before the Split-Off (see § 1.1502-19).
- (u) At the time of the Split-Off, Distributing will not have an excess loss account in the stock of Controlled or in the stock of any Controlled subsidiary.
- (v) Apart from payments (or the absence thereof) under the Business Agreement(s), payments made in connection with all continuing transactions between Controlled (or any entity controlled directly or indirectly by Controlled) and Distributing (or any entity controlled directly or indirectly by Distributing) will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.
- (w) No two parties to the Split-Off are investment companies as defined in § 368(a)(2)(F)(iii) and (iv).

- (x) Each of the offerings of Class A Stock to employees of Controlled is or may be part of a plan or series of related transactions (within the meaning of § 1.355-7) that includes the Split-Off. Taking all of these current and future offerings into account, stock representing a 50-percent or greater interest (within the meaning of § 355(d)(4)) in Distributing or Controlled (including any predecessor or successor of any such corporation) will not be acquired by any person or persons.
- (y) Immediately after the transaction (as defined in § 355(g)(4)), either (1) no person will hold a 50-percent or greater interest (within the meaning of § 355(g)(3)) in Distributing or Controlled, (2) if any person holds a 50-percent or greater interest (within the meaning of § 355(g)(3)) in any disqualified investment corporation (within the meaning of § 355(g)(2)), such person will have held such interest in such corporation immediately before the transaction, or (3) neither Distributing nor Controlled will be a disqualified investment corporation (within the meaning of § 355(g)(2)).
- (z) The Recapitalization will qualify as a tax-free reorganization under § 368(a)(1)(E).

RULINGS

Based solely on the information submitted and the representations set forth above, we rule as follows:

- (1) The Contribution, followed by the Split-Off, will be a reorganization under § 368(a)(1)(D). Distributing and Controlled will each be “a party to the reorganization” under § 368(b).
- (2) No gain or loss will be recognized by Distributing on the Contribution (§§ 357(a) and 361(a)).
- (3) No gain or loss will be recognized by Controlled on the Contribution (§ 1032(a)).
- (4) The basis of each asset received by Controlled in the Contribution will equal the basis of that asset in the hands of Distributing immediately before the Contribution (§ 362(b)).
- (5) The holding period of each asset received by Controlled in the Contribution will include the period during which Distributing held that asset (§ 1223(2)).

- (6) No gain or loss will be recognized by Distributing on the distribution of the Controlled Common Stock in the Split-Off (§ 361(c)(1) and (2)).
- (7) No gain or loss will be recognized by any Participating Shareholder on the Split-Off (§ 355(a)(1)).
- (8) The aggregate basis of the Controlled Common Stock in the hands of each Participating Shareholder immediately after the Split-Off will equal the aggregate basis of the Distributing Common Stock surrendered in exchange therefor (§ 358(a)(1)).
- (9) The holding period of the Controlled Common Stock received by each Participating Shareholder in the Split-Off will include the holding period of the Distributing Common Stock surrendered in exchange therefor, provided that the Distributing Common Stock was held as a capital asset on the date of the Split-Off (§ 1223(1)).
- (10) Earnings and profits, if any, will be allocated between Distributing and Controlled in accordance with § 312(h) and §§ 1.312-10(a) and 1.1502-33(e)(3).
- (11) Following the Split-Off, Controlled will not be a successor of Distributing for purposes of § 1504(a)(3). Therefore, Controlled and its direct and indirect subsidiaries that are “includable corporations” (under § 1504(b)) and satisfy the ownership requirements of § 1504(a)(2) will be members of an affiliated group of corporations entitled to file a consolidated federal income tax return with Controlled as the common parent.
- (12) The True-Up Payment made between Distributing and Controlled that (i) will arise for a taxable period ending on or before the Split-Off or for a taxable period beginning before and ending after the Split-Off and (ii) will not become fixed and ascertainable until after the Split-Off, will be treated as occurring before the Split-Off (*cf. Arrowsmith v. Commissioner*, 344 U.S. 6 (1952); Rev. Rul. 83-73, 1983-1 C.B. 84).
- (13) The Required Distribution, the Estimated Amount, and the True-Up Payment will each be a distribution of property made by the Business B Entities to Distributing with respect to the stock of the Business B Entities prior to the Contribution (§ 301(a) and § 1.1502-13(f)(2)(iv)).

CAVEATS

No opinion is expressed about the tax treatment of the Proposed Transactions under other provisions of the Code and regulations or the tax treatment of any conditions existing at the time of, or effects resulting from, the Proposed Transactions that are not specifically covered by the above rulings. In particular, no opinion is expressed regarding:

- (i) Whether the Split-Off satisfies the business purpose requirement of § 1.355-2(b);
- (ii) Whether the Split-Off will be used principally as a device for the distribution of the earnings and profits of Distributing or Controlled or both;
- (iii) Whether the Split-Off will be part of a plan (or series of related transactions) under § 355(e)(2)(A)(ii); and
- (iv) The tax treatment of the Restrictive Stock Redemption, the Post-Split-Off Redemption, the Post-Split-Off Exchange, or the Employee Class A Purchase.

PROCEDURAL STATEMENTS

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Gerald B. Fleming
Senior Technician Reviewer, Branch 2
Office of Associate Chief Counsel (Corporate)

cc: